NATIONAL SEMINAR
ON
SECURITIES LAWS AND CAPITAL MARKET – THE ROAD AHEAD

BACKGROUNDER

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3

FURTHER REFORMING SECURITIES LAWS

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RECENT LEGISLATIVE REFORMS

The authorities have been quite sensitive to requirements of development of securities market, so much so that during last decade, there were seven special legislative interventions, including two new enactments, namely the SEBI Act, 1992 and the Depositories Act, 1996, to accommodate developments in the securities market. The SEBI Act and the Securities Contracts (Regulation) Act (SCRA), 1956 were amended five times each in the last decade. The developmental need was so urgent at times that the last decade witnessed four ordinances relating to securities laws. Besides, a number of other legislations (the Income Tax Act, the Companies Act, the Indian Stamps Act, the Bankers' Book Evidence Act, the Benami Transactions (Prohibition) Act etc.) were also amended. These indicate importance of reforms in securities laws for development and regulation of the securities market and protection of investors in securities.

The legal reforms began with enactment of the *SEBI Act, 1992*, which established SEBI with statutory responsibility to (i) protect the interests of investors in securities, (ii) promote the development of the securities market, and (iii) regulate the securities market. This was followed by repeal of *the Capital Issues (Control) Act, 1947* in 1992 which paved way for market determined allocation of resources. Then followed *the Securities Laws (Amendment) Act in 1995*, which extended SEBI's jurisdiction over corporates in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It empowered SEBI to appoint adjudicating officers to adjudicate a wide range of violations and impose monetary penalties and set up Securities Appellate Tribunal (SAT) to hear appeals against the orders of the adjudicating officer. Then followed *the Depositories Act in 1996* to provide for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. It made securities of public limited companies freely transferable subject to certain exceptions; dematerialised the securities in the depository mode; and (c) provided for maintenance of ownership records in a book entry form. It also exempted stamp duty in respect of transactions in demat securities. *The Securities Laws (Amendment) Act, 1999* was enacted to provide a legal framework for trading of derivatives of securities and units of collective investment schemes. *The Securities Laws (Second Amendment) Act, 1999* was enacted to empower SAT to deal with appeals against orders of SEBI under the Depositories Act and the SEBI Act, and against refusal of stock exchanges to list securities under the SCRA. *The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002* included security receipts issued by securitisation and reconstruction companies within the ambit of the 'securities' under the SCRA. The latest intervention is *the SEBI (Amendment) Act, 2002* which enhanced powers of SEBI substantially in respect of inspection, investigation and enforcement. The investigating authority appointed by SEBI can enter a place, search it and seize documents and records considered necessary for investigation. It enhanced penalties for the offences from a maximum of Rs. 5 lakh to a maximum of Rs. 25 crore or three times the amount of profit made out of violation, whichever is higher. Another legislative intervention is on anvil to amend the SCRA to provide for demutualisation of stock exchanges, as indicated by the Finance Minister in his budget speech for 2003-04.

Besides these special securities laws, many other laws having bearing on securities market have been amended in the recent past to complement amendments in securities laws. For example, in order to boost the process of corporatisation of membership of exchanges, the Income Tax Act was amended to exempt capital gains tax on

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conversion of proprietary/partnership membership to corporate membership. The Companies Act, 1956 was amended to establish 'Investor Education and Protection Fund' for promotion of investor awareness and protection of their interest.

FURTHER REFORMS

Though the above reforms aided and abetted development of securities market and enhanced protection of investors in securities, this paper explores the scope for improving the legal framework.

I. Regulatory Issues

There are several statutes regulating different aspects of the securities market. The four main legislations governing the securities market are: (a) the SEBI Act, 1992 which establishes SEBI to protect investors and develop and regulate securities market; (b) the Companies Act, 1956, which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of securities, and disclosures to be made in public issues; (c) the SCRA, 1956 which provides for regulation of transactions in securities through control over stock exchanges; and (d) the Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of demat securities. The larger the number of laws, higher is the scope for inconsistency among them and the possibility of regulatory overlaps and gaps. For example, listing is provided for in the Companies Act, SCRA and SEBI Act, while law does not provide for certain areas such as delisting of securities, clearing corporation, continuous public holding for continued listing. These gaps are being made up through SEBI circulars, bye laws of the exchanges, and the listing agreement.

There are also as many regulators as the number of laws. The responsibility for supervision and development of the securities market is shared by Department of Economic Affairs (DEA), Department of Company Affairs (DCA), RBI and SEBI. For example, specified powers under the Companies Act, 1956 in respect of listed companies are exercised by SEBI while DCA administers those powers in respect of unlisted companies. Similarly, many powers under the SCRA are exercised concurrently by SEBI, RBI and DEA, as may be seen from Table-1.

Table 1

Supervisory Responsibility under the SCRA

Sections	*Responsibility*	*Administered by*
6, 9, 10, 13A, 17	Call for periodical returns or direct inquiries to be made, Approval of Bye-Laws of recognised stock exchanges, Make or amend bye-laws of recognised stock exchanges, Approval for additional trading floor, Licensing of dealers in securities	SEBI
3, 4, 5, 7, 7A, 8, 11, 12, 13, 14, 18, 28	Application for recognition of stock exchanges, Grant of recognition to stock exchanges, Withdrawal of recognition, Submission of Annual Report, Rules restricting voting rights, Direct rules to be made or to make rules, Supersede governing body of a stock exchange, Suspend business of stock exchanges, Contracts in notified areas illegal in certain circumstances, Contracts in notified areas void in certain circumstances, Exclusion of spot delivery contracts, Inapplicability of the Act in certain cases	DEA and SEBI
16	Prohibit contracts in certain cases	DEA, RBI and SEBI
22A	Appeal against refusal by stock exchanges to list securities of public companies	SAT
All other powers under the Act		DEA
Securities Contracts (Regulation) Rules, 1992		SEBI
Rules, Regulations and Bye-Laws		Exchanges

In view of involvement of so many regulators, there is scope for confusion among the regulators and the regulated, regulatory gaps and overlaps, and duplicate and inconsistent regulations. For example, no regulator regulated CIS till it assumed scandalous dimension when it was explicitly assigned to SEBI. Similarly, there is hesitation among regulators to regulate private placement of securities. The delay in initiating action against companies found guilty of market manipulation is generally attributed to the turf war between SEBI and DCA.

Not only the regulatory jurisdiction among different agencies is blurred, but also there is no formal arrangement to ensure regulatory coordination among them on day to day basis, although the High level Committee on Capital Markets, which comprises of the heads of these regulatory agencies, endeavours to provide coordination at policy level. There is no formal provision to provide for regulatory cooperation / sharing information among the domestic regulators and between overseas and domestic regulators. Powers of the regulator to assist / seek assistance from overseas regulators or to enter into MOUs or other co-operation arrangements with them to deal with cross border misconduct are not explicitly provided in the legislation. These are also not forbidden. SEBI has, however, entered into MOUs for sharing of information with regulators overseas.

Since some of the regulators also participate in the market, it may not always be possible to avoid conflict of interest. For example, RBI, which is manager of the monetary policy, acts as regulator for government securities market, and also participates in the market simultaneously as manger of government debt, issuer of securities, merchant banker to issue, registrar and transfer agent, clearing and settlement agent, depository for securities, provider of trading platform, and subscriber to securities. The decisions relating to debt management, interest rate and regulation of market should be taken independently to avoid perceived conflict of interest.

The protection of the interests of investors requires consolidation of all laws relating to securities market into a single piece of legislation, preferably called the Securities Act and assigning its administration to one agency with clearly defined regulatory jurisdiction and accountability. This requires transfer of powers exercised by Department of Economic Affairs and RBI to SEBI. It is all the more necessary as the government securities are traded on stock exchanges, which are under regulatory jurisdiction of SEBI. And this piece of legislation should prevail over general laws like the Companies Act, the Consumer Protection Act, the Contracts Act, etc and the agency works in close coordination with regulators, domestic and foreign, for other areas of financial market.

Private placement of securities has emerged as the major route for raising resources. This route accounted for 89% resources mobilized domestically by corporate sector during 2001-02. The convenience of structuring of issues to match the needs of issuers with those of investors coupled with savings in terms of time and cost has contributed to rapid growth of market for private placement. The issues by private placement do not require prospectus, disclosures, or a rating. This development reflects regulatory arbitrage and it is feared that private placement has crowded out public issues. If this route is to continue as a major source of resources, this requires to be subjected to regulatory discipline. SEBI, being regulator for securities market, is obliged to protect the interests of investors in securities, whether privately or publicly issued, or whether issued by listed or unlisted companies. It needs to come up quickly with a regulatory framework for issue and trading of privately placed securities.

Units of mutual funds resemble securities. Though, the holders of units and securities have the same need for safety, liquidity and return, they are not explicitly treated legally at par. The easiest way to develop the market for units of MFs and protect the investors investing in them is to consider the units to be securities so that the regulatory framework applicable to trading of securities would also apply to trading of units and SEBI which has the responsibility to protect the interests of investors in securities, can protect the interest of holders of units of MFs also.

The securities laws do not explicitly recognise existence of clearing corporation. They talk only about trading and not about settlement, which is left to byelaws of the exchanges. The byelaws are supposed to provide for clearing house (not clearing corporation) for settlement of securities transactions. Except NSE, all exchanges have their departmental clearing houses. Risk management requires that all exchanges are required to use the services of a clearing corporation and this is mandated in law. It is not necessary that each stock exchange must have its own exclusive clearing corporation. It may be better if the stock exchanges use the services of a clearing corporation or a few clearing corporations, as they share the depository services. Such an arrangement allows the clearing corporation to have an overall view of gross exposure position of traders across the stock exchanges and is much better geared to manage the risk. However, to provide for necessary competition, it is essential that there are at least two clearing corporations, just as this has been ensured in the case of depositories. As the clearing corporation guarantees

financial settlement, it is necessary that it has first lien over the assets of insolvent clearing members and the income of clearing corporation is exempted from tax.

The SROs are expected to share the responsibility with the regulator in framing and administering regulations SEBI is, therefore, mandated to promote and regulate SROs. However, the SROs have not developed appreciably in India. Most of the associations of intermediaries like, AMFI, AMBI do not exactly regulate, though promote the activities of their members. The stock exchanges are SROs in true sense. However, the current ownership and governance structure of many stock exchanges do not seem adequate to deal with conflict of interest objectively The imminent demutalisation should address this.

The SCRA permits different structures for stock exchanges. That is why some exchanges are association of persons, some are company limited by shares, and some others are company limited by guarantee. Since the law permits any form for a stock exchange, it may not be possible to mandate a particular (corporate) form for all exchanges, unless the SCRA is amended. Further, demutualisation would result in two classes of members namely, trading members and shareholding members. Since "member" under the SCRA means a member of the recognised stock exchange, the SCRA needs to be amended to provide for shareholder members.

While formulating regulations, no conscious effort is made to estimate cost of compliance of regulations and if the benefits from regulation outweigh the costs of regulation. There has also not been any study to estimate the cost of regulation / compliance. In order to prevent over regulation, it is necessary that the regulators explicitly take into account the costs of regulation.

There is no provision in law requiring regulator to consult the regulated while formulating regulations. SEBI has, however, recently instituted a consultative process before framing regulations. All major policy / regulatory issues are evolved through a committee comprising of experts and market participants. The reports / concept papers / policy proposals evolved through committees are posted on SEBI web site for comments from market participants and public. The comments received are considered before finalising regulations. Despite this, market participants feel that there is still scope for increasing interaction between regulator and the regulated.

II. Penal Provisions

The securities market is an integral part of the economy. It has the potential to destabilise other sectors. It is therefore necessary that the penalty for offences in the securities market is deterrent. The first step in this regard is to make all the offences in the securities market cognisable, as a few offences under the SCRA are.

The penalty amounts for the offences under the SEBI Act, 1992 have been increased substantially by the SEBI (Amendment) Act, 2002. However, the penalty prescribed under the SCRA is ridiculously low. Many of the offences under the SCRA attract a penalty of Rs. 1000, on conviction. For example, non-compliance of listing agreement, which can put investors to untold miseries and make a mockery of corporate governance norms, can be punished upto Rs. 1000. Listing agreement can be effectively used to discipline a listed company, if its non-compliance invites a deterrent penalty.

SEBI needs to be empowered to penalise the exchanges/depositories for different types of violations. As of now, only recourse available to SEBI against an erring Stock Exchanges / depository is to withdraw recognition/ cancel registration. Very often the violation may not warrant such extreme punishment and such punishment affects tnird parties. It is therefore, desirable that SEBI has powers to impose monetary penalty on an erring stock exchange / depository. Further, though law provides re-examination or withdrawal of approval of trading system, no exchange has ever been derecognized, even though most of them have lost relevance. Besides, many exchanges have permanent recognition which probably can not be withdrawn.

The SEC lets off the offenders who simply pay up without admitting to an offence. This prevents every case being locked up in a court. Given the number of cases pending in the Indian courts and intangible nature of securities market offences (it is difficult to track evidence since the securities are issued, traded, cleared, settled and transferred electronically in demat form), SEBI requires similar facilities if the offenders are to be punished on priority. This would help to bring all the co-accused to book or solve difficult cases if one accused provides lead by agreeing to plea bargain in exchange of a lenient sentence. A beginning has been made by allowing central government to grant immunity to an accused if he makes a full and true disclosure about the alleged violation.

The penal provisions in the SEBI Act, 1992 need a little more fine-tuning. The Act provides for two alternative types of punishment for violations of the provisions of the Act, in addition to prosecution and directions. They are: (a) suspension or cancellation of certificates of registration to be imposed by SEBI only as per Regulations framed by it, or (b) monetary penalty to be imposed by an adjudicating officer, appointed by SEBI, as per Rules framed by government. These two types of punishments are mutually exclusive, not and/or punishments. If a violation is assigned to an adjudicating officer for adjudication or monetary penalty is imposed, penalty of suspension or cancellation of certificate of registration can not be imposed and vice-versa. As per the scheme of the Act, SEBI shall appoint an officer to adjudge if some body has contravened any of the provisions of sections 15A to 15HB of the Act. Once such an adjudicating officer is appointed, SEBI loses control over the case and the adjudicating officer decides the case on merit. The adjudicating officer can at best impose monetary penalty even if he finds that the violation really warrants suspension or cancellation of registration. Similarly, if SEBI initially considers a case for suspension or cancellation, it can not impose monetary penalty even if it concludes that the violation warrants monetary penalty. This happens because SEBI does not have power to impose monetary penalty and the adjudicating officer does not have power to suspend or cancel a certificate of registration. A corollary of this is that mind is made up about the type of punishment to be imposed on the erring party when the alleged violation is referred to an adjudicating officer for adjudication or taken up by SEBI for imposition of suspension or cancellation of registration, that is, at a stage when the nature and gravity of the violation has not been fully ascertained. What would, therefore, be desirable is to authorise the adjudicating officers to try all offences under the SEBI Act, rather all securities laws, and award suspension/cancellation of registration and/or monetary penalties so that SEBI can concentrate on developmental and regulatory work.

III. Investor Protection

Investors are the backbone of the securities market. Protection of their interest is essential for sustenance of their interest in securities and hence development of market.

The consumer fora provide an expeditious remedy to a consumer who has suffered loss on account of deficiency in goods/services purchased by him. A similar arrangement is called for redressal of investor grievances, given the rate of disposal of our judicial system. A system of ombudsman may be introduced for redressal of grievances of investors in securities against the listed companies and intermediaries.

The investor forum as well as other authorities should have power to dispose off the cases summarily and to award compensation to the investor. It is not enough if the culprit is punished. The culprit needs to be punished in an exemplary manner, while investor should have means to recover his loss caused by the culprit. The SEBI Act should empower SEBI not only to levy penalties, but also award compensation to investor.

The depositors are protected up to Rs. 1 lakh in the event of liquidation/bankruptcy of a bank. This protects innocent depositors and thereby contributes to the stability of the financial system. A similar mechanism may be insituted to compensate an investor up to Rs. 5 lakh if he suffers a loss on account of the failure of the system or mischief by any market participant. An organisation called Securities Investor Protection Corporation operates in the USA to provide similar protection to investors.

It is argued in some circles that delisting should not be permitted at all. They argue that it is the intention of legislature, as there are statutes and rules to govern listing, but no statute/rule provides for delisting. Only law that governs delisting is a guideline of SEBI. The statute provides for listing, it must also provide a framework for delisting. If it is in the interest of investors, it must be permitted. If it is not in the interest of investors, delisting may be allowed only if investors are adequately protected. Non-compliance of listing agreement should not be a ground for delisting. The terms and conditions of listing have to be enforced by recourse to other means rather than delisting.

The confidence of the investors can be maintained and enhanced by making provision for professional intermediation services. Industry/SROs/Regulators have made a modest beginning, but not adequate given the dimensions of the market. A reputed testing system, as may be accredited by SEBI, may offer a certification for each type of intermediation service. SEBI may determine the syllabus and standards for such certification in consultation with industry associations. The certified people may be required to update their skills and expertise by seeking certification at intervals of five years. The personnel having supervisory responsibilities with intermediaries and issuers, and also officers working with SROs and regulators need much broader exposure (equivalent to Principle of NASDR). There are institutes like the ICSI for grooming professionals for secretarial work or the ICAI for accounting

work. A similar institute, say National Institute of Securities Market (NISM), may be statutorily set up with the responsibility to develop a distinct group of professionals for a career in the securities market. The personnel with supervisory responsibilities must at least be associates of the NISM. SEBI regulations, which lay down various requirements for registration as an intermediary, should specify certification as a mandatory requirement for operational level employees and associate membership of NISM for supervisory level employees. NISM may maintain a database of its associates as well as certified professionals and enforce a code of conduct for them so as to enable prospective employers to access the database to meet their personnel requirements.

An investor normally deals in securities through an intermediary, whose acts of omission and commission can cause loss to him. In order for the investor to choose the right intermediary through whom he may transact business, it may be useful to help him in taking informed decision by making details of intermediaries available to him. The details may include the form of organization, management, capital adequacy, liabilities, defaults and penal actions taken by the regulator and self-regulatory organizations against the intermediary in the past and other relevant information. If possible, the intermediaries may be rated and their ratings are disseminated.

The sustenance of investors' interest and confidence in the securities market depends crucially on corporate governance. An investor, however, is generally not equipped to form an idea about the level of corporate governance in a company. As he is helped by credit rating in respect of his investments in debt instruments, he needs to be helped by a summary figure such as corporate governance index in respect of his investments in the concerned company.